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SUBJECT: New German Government Plans for Reform of Financial
Supervision Raise Questions and Criticism

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¶1. (SBU) Summary: As one of its first decisions, the new coalition government in Germany agreed to concentrate banking supervision, which has previously been shared by Germany's financial supervisor, BaFin, and the German central bank, Bundesbank, in the hands of the central bank.
Proponents of the reform claim that the current supervisory structure has exacerbated the financial crisis.
Critics deny that re-designing the institutional structure would improve financial supervision and claim that the move is primarily political as the current dual system was introduced under Schroeder's Social Democratic Party (SPD) government. Additionally, some believe that the intended reforms may create a conflict of interest between monetary policy geared towards price stability and supervisory responsibility for financial stability. This tension may ultimately damage the central bank's reputation. End Summary.

Early Harvest

¶2. (U) The Christian Democratic Union (CDU), its Bavarian sister party the Christian Social Union (CSU) and the pro-business Free Democratic Party (FDP), all campaigned on platforms promising to concentrate banking supervision in the hands of the German central bank (Bundesbank). Just ten days after the September 27 elections this was the first issue on which the new coalition agreed. However, in the new government's written coalition agreement many of the more difficult details on the merger were not addressed.

¶3. (U) Current proponents of the reforms argue that regulatory failures, in particular, insufficient coordination and cooperation between BaFin and the Bundesbank, have aggravated the financial crisis in Germany. The German Council of Economic Experts argues that a merger of banking and insurance supervision under the Bundesbank would ensure more effective macro-prudential supervision. However, the Council is silent on how the duties would be legally divided.

Current Financial Supervisory Arrangement

¶4. (U) BaFin and the Bundesbank currently share responsibility for banking supervision. The Bundesbank monitors the operations of banks on an ongoing basis, analyzing bank reports and assessing whether their capital and their risk management procedures are adequate. It reports its findings to the Federal Financial Supervision Agency, BaFin, which has regulatory decision-making powers. BaFin is responsible for managing and licensing banks, and acting against banks that do not meet regulatory requirements. BaFin

is also (exclusively) in charge of insurance and securities trading supervision.

¶5. (U) BaFin was established in 2002 as a single financial regulator (replacing three separate agencies that individually supervised banking, insurance, and securities) with the objective of creating integrated financial supervision, a move which reflected an international trend at the time. BaFin was headquartered in Bonn due to the available government office space there after the capital moved to Berlin, even though Frankfurt is Germany's financial capital. BaFin officials told the Embassy that its distance from Frankfurt enabled it to be more objective.

Contentious Political History

¶6. (SBU) Banking supervision has remained a hotly debated topic due to the political circumstances that brought BaFin to life. BaFin was born by "precipitate delivery," according to Peter Abrahams, BaFin's insurance sector spokesman. The Act establishing BaFin easily passed with the votes of Schroeder's governing Social Democratic Party (SPD)/Green coalition government, because, according to sources at BaFin, the Christian Democratic Union (CDU) faction had left en bloc in protest during a prior vote and did not return in time to vote on BaFin. The CDU thus was dealt a political defeat that it has never fully digested, according to Bernhard Speyer, Head of Banking, Financial Markets and Regulation at Deutsche Bank Research.

Seizing the Opportunity: The Bundesbank's Plan
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¶7. (U) Although the new German government presented few details on the BaFin-Bundesbank reorganization, the Bundesbank quickly seized the moment to present its own version. Only three days after the

federal election, Bundesbank President Axel Weber declared the Bundesbank ready to take on more responsibilities. On October 2, the six-member executive board unanimously approved a six-point plan for concentrating financial oversight at the Bundesbank. Under this plan, the bank would not only take over banking, but also insurance supervision leaving only the securities supervision to BaFin. (Comment: the insurance sector subsequently protested the plan and it appears unlikely that insurance supervision will be transferred to the Bundesbank. End Comment.) The proposal gives the Ministry of Finance veto power over all decisions. "Administrative acts of high intensity" such as bank closures would also be left to the Ministry.

BaFin's Response

¶8. (SBU) The president of BaFin, Jochen Sanio, considers the planned reforms political. The reorganization, he predicted in a discussion with Consulates Duesseldorf and Frankfurt, "would allow the new coalition government to score an early political success." The Bundesbank has been in search of a new mission ever since it has lost its core competence, monetary policy making, with the creation of the European Central Bank, he opined. In addition, Weber is trying to enhance his personal powers after his chances to succeed ECB president Jean-Claude Trichet have waned, with Mario Draghi, the Chairman of the Financial Stability Board (FSB), entering the race. Draghi has been the "undisputed number one of international finance" since Timothy Geithner bestowed the FSB the "highest honors" by declaring it the "fourth pillar" of the financial system.

¶9. (SBU) According to Sanio, the current division of labor between Bafin and Bundesbank has been a success and has strengthened Germany's position in international fora. Sanio argued that to dissolve the current arrangement would weaken Germany, especially now after the crisis has shown the need for strong cross-sectoral supervision. Further, concentrating exclusively on national reforms while the new EU regulatory structure is being set up is ill-timed.

Banking Sector Response: It's Political

¶10. (SBU) The new government's reform plan has provoked negative reactions from the banking industry. Norbert Walter, Chief Economist of Deutsche Bank Group, called the plan "an archaic reflex of politicians that do not trust anybody but the Bundesbank." DB Research's Bernhard Speyer noted there is no evidence available that the current supervisory structure aggravated the impact of the financial crisis in Germany. Other countries' experience does not suggest that allocating the task of banking supervision to the central bank yields superior results. Many, like Dr. Ulrich Kater, Chief Economist of Deka-Bank, have cautioned that much of the blame for regulatory failures during this crisis was deflected from the Bundesbank and fell on BaFin. Otto Steinmetz, former head of risk management at Dresdner Bank pointed out that BaFin was at times constrained from taking decisive action by political considerations in Berlin.

Potential Conflict of Interest

¶11. (SBU) The key concern of the banking sector, however, is the potential conflict of interest between monetary policy geared at price stability and the supervisory responsibility for financial stability. The execution of sovereign powers, such as closing banks or removing senior management from office, Norbert Walter argued, is not compatible with central bank autonomy in the conduct of monetary policy. The Bundesbank might be forced to make monetary decisions in the ECB Governing Council that burden the financial institutions that it supervises to the point where they could even become a systemic risk. Installing "Chinese Walls" as the Bundesbank plan suggests, "is a fiction as we all know," Otto Steinmetz, former head of risk management of Dresdner Bank, said. The reputation of the Bundesbank is at stake fears Ulrich Kater, Chief Economist of Deka-Bank.

¶12. (SBU) This conflict could, Walter contended, be carried through the Bundesbank into the European Central Bank, making it more likely to be soft on inflation. Some would call this hyperbole. Fabio Recine, senior expert on Financial Supervision of the ECB, argues instead that, "monetary policy is decided by the entire Governing Council; any reputational damage therefore does not apply to the ECB." However, Racine does believe that a central bank should remain independent from the Ministry of Finance. If the Bundesbank

jurisdiction were to be extended to the insurance sector, there could be a legal conflict with Article 105 (6) of the EU Treaty that explicitly excludes insurance supervision from the ECB's powers.

Compensation for Regulators

¶13. (U) Some believe that the real problem with financial supervision in Germany is the insufficient resources and competences of the regulators. Uncompetitive remuneration makes it difficult to attract and keep highly qualified staff. As a result, "even Bundesbank staff is less qualified than those working at the institutions they oversee," said Otto Steinmetz. The lack of a waiting period before a regulator can move over to the private sector is also part of the problem. Joerg-Matthias Butzlaff, Head of Communications of Metzler Bank, compared the relationship between the regulators and the regulated to a race of "a Golf against a Ferrari".

Comment

¶14. (SBU) The planned reorganization of German banking supervision appears to be motivated at least in part by politics. Many in the banking community believe that the move will not improve the performance of the country's financial supervisors. The current restructuring discussion comes at the same time as the implementation of new European supervisory regulations. Given its focus on the BaFin-Bundesbank debate, it is not clear that Germany is putting its best foot forward in discussions at the European level. END COMMENT

¶15. (U) This cable has been coordinated by Embassy Berlin and Consulate Dusseldorf.

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